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201008—41

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 137

CHARLES PETTIT, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 54–60) is reported in 41 B. T. A. 264. The opinion of the Circuit Court of Appeals (R. 73–75) is reported in 118 F. (2d) 816.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 22, 1941 (R. 76). The petition for a writ of certiorari was filed on June 6, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the income realized by petitioner during the taxable years from certain oil payment contracts should be treated for income tax purposes as ordinary income, subject to depletion allowance, as determined by the Commissioner, or as gain derived from the sale of a capital asset, as contended by the petitioner.

STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra,* pp. 10–11.

STATEMENT

The pertinent facts as found by the Board of Tax Appeals (R. 48–54) may be summarized as follows:

During the years involved, petitioner and his wife were domiciled at Dallas, Texas, and filed separate income-tax returns. They kept their books and rendered their returns on the basis of cash receipts and disbursements, and all of their income and all of their allowable deductions for the years in controversy were community income and deductions (R. 48).

The petitioner and his wife entered into 31 written contracts with various persons involving oil and gas leases. Nine of these contracts are referred to as "barrel" contracts and the others as "dollar" contracts. Under eight of the barrel contracts (Exs. 1–8), the vendors sold to peti-

tioner and his wife and agreed to deliver to them if, as, and when produced, a specified number of barrels of oil from a specified fractional part of the total production from the particular leased premises. The other barrel contract represented a sale by petitioner and his wife of their interests in an oil lease for $5,000 and a reservation of 210,000 barrels of oil in place (R. 48).

Petitioner acquired nine of the so-called dollar contracts (Exs. 16, 23, 24, 26–31) from the owners of the working interests (i. e., the lessees) of certain oil and gas leases. Under these contracts, petitioner and his wife acquired the right to the proceeds of the sale of certain fractional parts of all oil and gas which might be produced and sold from the wells on the leases, until they had received a certain specified sum of money. Under eleven of the other dollar contracts (Exs. 11–15, 17, 19–22, 25), petitioner and his wife acquired interests in various oil payments. The remaining two dollar contracts (Exs. 10, 18) represented assignments by petitioner and his wife of their interests in oil and gas leases, petitioner and his wife reserving the right to receive a specified sum of money payable out of a fraction of the oil produced and saved from the leases (R. 48–49).

None of the contracts imposed any personal obligation on the assignors to deliver to petitioner and his wife the specified number of barrels of oil or to pay them the specified sums of money;

petitioner and his wife were accordingly required to look to the oil alone for the return of their capital investment. If there were no production, no right to any payment would arise. If there were production, the right to payment would be limited to the fraction of the oil out of which the barrels of oil or sums of money were to be delivered or paid (R. 49).

Each of the 31 contracts contained a conveyance clause similar to the following clause contained in the contract with the Inland Oil Company (Ex. 1):

> This conveyance is intended to have all of the effect of a deed to the said oil hereby conveyed to the buyer out of the seven-sixteenths (7/16) of all of the oil produced and saved from the aforesaid leases herein provided, and any pipe line company or other purchasers of oil from said tract shall so treat this agreement, and it shall not be necessary for the Seller to execute to the buyer any further conveyances or other instruments to enable the Buyer to receive full performance hereof.

Prior to the execution of the contracts, petitioner and his wife had no interest either in the properties to which the contracts were applicable or in the oil and gas leases on the properties, except in the case of the three contracts (Exs. 9, 10, 18) in which petitioner and his wife were the vendors or assignors. The leasehold estates to

which the contracts were applicable were developed by other persons without cost to petitioner and his wife. Petitioner and his wife had nothing whatever to do with, and paid no part of, the cost of drilling the wells on the leasehold estates or producing the oil therefrom (R. 51).

The operators of the leasehold estates to which the contracts were applicable arranged with pipe line companies to purchase and run the oil produced from the wells. In each instance petitioner and his wife executed what is known as a "division order" to the purchasing pipe line company (R. 51).

At the time of the Board's decision, the wells on the leaseholds covered by petitioner's contracts were permitted to produce oil only five days a week, with a maximum production of a fraction more than 22 barrels a day. Under this restriction, from three to thirty years would be required for petitioner to receive the number of barrels of oil or the number of dollars out of the sale of oil to which he was entitled (R. 53).

The oil that is produced from the wells is accumulated on the property in storage tanks. At irregular intervals, depending upon the amount of storage, the oil is run from the storage tanks into pipe lines belonging to the purchasing pipe line companies. Petitioner and his wife have nothing to do with the running of this oil. The pipe line companies purchasing the oil pay them

once a month for the amount they are entitled to receive under the contracts (R. 53).

In their returns for the years in controversy—1934, 1935, and 1936—petitioner and his wife treated the proceeds which they received under the contracts as proceeds from the sale or exchange of capital assets. For the years 1934 and 1935, they deducted from the amounts received from the sales of oil a proportionate part of the cost of each contract and reported a percentage of the balance, the percentage depending on the length of time the contract had been in force. For the year 1936, they deducted from the amounts received in each instance a proportionate part of the cost of the contract or percentage depletion, whichever was greater, and reported a percentage of the balance in gross income, the percentage depending on the length of time the contracts had been held (R. 52).

The Commissioner included in gross income the entire amount received under the various contracts and allowed as a deduction cost or percentage depletion, whichever was greater (R. 52). His action was sustained by the Board of Tax Appeals (R. 60). The court below affirmed (R. 76).

ARGUMENT

The only question in this case is whether the petitioner is entitled to report income derived from oil payment contracts as gain from the sale or exchange of capital assets within the meaning

of Section 117 of the Revenue Acts of 1934 and 1936, *infra*. Under these contracts, the petitioner and his wife acquired the right to a definite amount of oil, or to a specified portion of the proceeds from the sale of oil, as, if, and when produced over a period of years. This gave the petitioner an economic interest in the oil in place. Cf. *Palmer* v. *Bender,* 287 U. S. 551, 557; *Anderson* v *Helvering,* 310 U. S. 404, 409. This interest may be "a capital asset" within the meaning of Section 117, but the petitioner has not sold this interest and he has not assigned any of his rights under the contracts. He has merely collected payments under the contracts and has continued to hold his interest in the oil in place, diminished from time to time by depletion.[1] Thus the proceeds which the petitioner asserts were derived from the sale of capital assets are actually income which has been produced from his interest.

There is no substantial difference between the proceeds here involved and the bonus payments considered in *Burnet* v. *Harmel,* 287 U. S. 103. There the lessor, the holder of a fee title, executed an oil and gas lease for a cash bonus and for stipulated royalties measured by oil production. In holding that the bonus was not a gain from the sale or exchange of capital assets, this Court

[1] Deductions on account of such depletion have been allowed (R. 52). However, if a sale of capital assets had occurred, as petitioner contends, no deduction for depletion would be permissible. *Palmer* v. *Bender*, *supra*.

stated that, although ownership of the oil and gas passed from the lessor to the lessee at some time, this could not be considered as the conversion of a capital asset. Production of oil under an oil and gas lease, the Court pointed out, is rather an income-producing operation.

It is immaterial that the petitioner had no part in the actual production of the oil; the decisive factor is that the payments to him, like those to the lessor in the *Harmel* case, were the result of, and entirely dependent upon, such production. In both cases the taxpayer had essentially the same type of economic interest in the oil and gas in place and in both cases the taxpayer realized income from that interest through the production and sale of the oil and gas by another.

The facts here are also similar to those in *Thomas* v. *Perkins,* 301 U. S. 655, which involved an assignment of a lease under which the assignor was to be paid solely out of oil as, if, and when produced.[2] This Court held that the provi-

[2] In one contract here (Ex. 9, R. 48), the petitioner and his wife sold their interest in an oil lease for a cash payment and for 210,000 barrels of oil in place. With respect to that contract the petitioner had the same kind of retained interest as in the *Perkins* case, *supra.* In two other contracts (Exs. 10, 18, R. 49), the petitioner and his wife assigned interests in leases, retaining the right to receive a definite sum payable out of the proceeds of a fraction of the oil produced. However, the parties do not appear to contend that for tax purposes there is any material difference in any of the thirty-one contracts.

sion in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same consequences as a provision for oil royalties. See *Anderson* v. *Helvering,* 310 U. S. 404, 411. Under the rule in *Burnet* v. *Harmel, supra,* this meant that the payments to the assignor were taxable as income to him.

The payments here involved cannot be distinguished for tax purposes from those in the *Harmel* and *Perkins* cases. Consequently, the decision below that the payments were taxable as income to the petitioner is in full accord with the controlling decisions of this Court. No conflict with any decision of this Court or with that of any other Circuit Court of Appeals is alleged in the petition, and, so far as we know, no such conflict exists.

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FAHY,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
J. LOUIS MONARCH,
LOUISE FOSTER,
Special Assistants to the Attorney General.

JULY 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

* * * * *

(U. S. C., Title 26, Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would be properly included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(U. S. C., Title 26, Sec. 101.)

Sections 22 and 117 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, contain provisions similar to the same numbered sections of the 1934 Act.

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